

HOUSE BILL REPORT

ESHB 2546

As Passed Legislature

Title: An act relating to high technology and research and development tax incentives.

Brief Description: Modifying high technology and research and development tax incentive provisions.

Sponsors: By House Committee on Finance (originally sponsored by Representatives McIntire, Morris, Hunter, Ruderman, Kessler, Lovick, Hunt, Grant, Hatfield, Fromhold, Clibborn and Clements; by request of Governor Locke).

Brief History:

Committee Activity:

Finance: 1/19/04, 1/23/04 [DPS].

Floor Activity:

Passed House: 1/30/04, 86-12.

Passed Senate: 2/10/04, 40-9.

Passed Legislature.

Brief Summary of Engrossed Substitute Bill

- Extends the business and occupation tax (B&O) credit for research and development (R&D) spending from December 31, 2004 to January 1, 2015.
- Extends the sales and use tax exemption for new, expanded, or diversified operations in R&D or pilot scale manufacturing from July 1, 2004 to July 1, 2015.
- Limits the R&D credit calculation to the amount of R&D expenditures in excess of 0.92 percent of taxable income and computes the credit for firms other than non profits using the firm's average tax rate rather than 1.5 percent.
- Allows University of Washington and Washington State University to use the sales and use tax exemption for R&D facilities and equipment. Includes federal contractors building federal R&D facilities in the exemption.
- Requires credit and exemption users to report annually on the amount of B&O tax credit or sales tax exemption taken; number of new products, trademarks, patents, and copyrights; number of jobs and the percent of full and part-time jobs; wages by salary band; number of jobs with employer provided health and retirements; and other company related information.

- Allows public disclosure of the amount of the sales tax exemption taken and the amount of credit taken for firms taking more than \$10,000 in annual credits.
- Requires the Department of Revenue to annually summarize by category the survey information and to study the credit and exemption and report to the Legislature by December 1, 2009 and December 1, 2013.
- Exempts amounts received from the federal small business programs for innovation research and technology transfers from B&O tax.

HOUSE COMMITTEE ON FINANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 5 members: Representatives McIntire, Chair; Hunter, Vice Chair; Conway, Morris and Santos.

Minority Report: Do not pass. Signed by 4 members: Representatives Cairnes, Ranking Minority Member; Orcutt, Assistant Ranking Minority Member; Ahern and Roach.

Staff: Rick Peterson (786-7150).

Background:

In 1994 the Legislature enacted tax incentives to encourage additional research and development (R&D) in the high-technology sector. The legislation allows businesses that conduct activities in advanced computing, advanced materials, biotechnology, electronic device technology, or environmental technology to take a credit against the business and occupation (B&O) tax and an exemption from sales and use taxes on construction of R&D and pilot scale manufacturing facilities.

A firm qualifies for the high technology B&O tax credit for R&D spending if the firm's spending on research and development exceeds 0.92 percent of B&O taxable income. For-profit firms may take a credit equal to 1.5 percent of R&D spending. The credit is equal to 0.484 percent of the R&D expenditures for nonprofit organizations. A maximum of \$2 million in credit is available each year to an eligible firm. The tax credit program expires on December 31, 2004.

Firms taking the B&O tax credit file an affidavit that includes the amount of credit claimed, an estimate of anticipated R&D expenditures for the year for which the credit is claimed, an estimate of taxable income for the year, and other information that the Department deems necessary to administer the credit.

Firms that create a new operation or expand or diversify a current operation in R&D or pilot scale manufacturing are eligible for a sales and use tax exemption on the project. The exemption includes sales and use tax on building construction and purchases of equipment. If

the investment project is used for a purpose other than qualified R&D or pilot scale manufacturing within the first eight years of operation, a proportionate share of exempted taxes must be paid.

Firms apply for the exemption before starting construction or equipment purchases. The application must include the location of the project, current employment, new employment estimates, estimated wages related to the project, estimated or actual cost data, time schedules for completion and operation, and other information required by the department. Applications for the program are not confidential and may be disclosed to the public. No new projects will be approved for exemption after June 30, 2004.

Participants in both tax incentives are required to supply the Department of Revenue (Department) with information necessary to measure the results of the tax credit program. The Department was required to do assessments of the programs in 1997, 2000, and 2003. The Department has estimated that about 600 firms utilize the B&O credit for R&D expenditures each year, resulting in tax savings of about \$25 million annually. About 50 to 60 businesses use the sales and use tax exemption each year with annual tax savings of about \$40 million. Firms in the advanced computing and biotechnology sectors have used the majority of the incentives. The majority of the incentives have been used in King County.

Under the federal small business innovation research program, grants are made to small businesses for research and development. Under the federal small business technology transfer program, grants are made for research and development to small business partnering with nonprofit research institutions. To be eligible for the programs, a business must be American owned, independently operated, for profit, employ the principal researcher, and have not more than 500 employees. Amounts received by a small business under these programs are subject to the B&O tax.

Sales tax is imposed on all sales to state and local governments other than sales for resale. The federal government is immune from direct taxation by the states unless Congress has specifically waived that immunity. States may impose indirect taxes on the federal government as long as the economic burden borne by the federal government is not greater than that borne by a similarly situated entity. Under current law, contractors on federal construction projects are considered the consumer of tangible personal property purchased or used by them. Therefore, the federal government is indirectly subject to the sales and use tax on the materials. The U.S. Supreme Court upheld this tax treatment in *Washington v. United States*, 460 US 536 (1983) explaining that as long as the burden on the federal government was not greater than the burden on other contractors for other governmental or private activities, the tax would be valid.

Summary of Engrossed Substitute Bill:

The business and occupation tax credit for research and development spending is extended from December 31, 2004 to January 1, 2015. The R&D credit is calculated on the amount of R&D expenditures in excess of 0.92 percent of taxable income. For taxpayers other than

nonprofit institutions, the credit is computed using the taxpayer's average tax rate rather than 1.5 percent. The affidavit that previously was filed with each tax return is changed to an annual report that is filed in the year following use of the credit.

The sales and use tax exemption for new, expanded, or diversified operations in R&D or pilot scale manufacturing is extended from July 1, 2004 to January 1, 2015. State universities (UW and WSU) may take the exemption. An exemption from sales and use tax is provided for federal contractors on materials purchased for an investment project that would be eligible for the deferral program if undertaken by a private entity.

Participants in both programs are required to complete an annual survey and provide information on the amount of B&O tax credit or sales tax exemption; number of new products, trademarks, patents, and copyrights; number of jobs and the percent of full-time, part-time and temporary jobs; wages by salary band; and number of jobs with employer provided health and retirement benefits. The Department of Revenue may request additional information necessary to measure the results of the programs. Information reported in the survey is confidential except the amount of B&O credit and the amount of sales tax exemption taken is not confidential. Businesses taking less than \$10,000 in B&O credit may request the credit amount be treated as confidential.

The survey is due by March 31. B&O tax credit participants may not take credits in any year they fail to complete the survey. Sales and use tax exemption participants must pay 12.5 percent of the tax exempted for each year they fail to complete the survey.

Each year by September 1, the Department of Revenue will prepare summary descriptive statistics by category from the information provided by the survey. No fewer than three taxpayers will be included in any category.

The Department of Revenue is required to study the B&O tax credit program and the sales and use tax exemption program and report back to the Legislature by December 1, 2009 and December 1, 2013.

Amounts received by businesses from the federal small business programs for innovation research and technology transfers are exempt from B&O tax.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of session in which bill is passed except for sections 9 and 10 relating to the B&O exemptions for amounts received from the federal small business programs for innovation research and technology transfers, which takes effect on July 1, 2004.

Testimony For: These incentives were enacted in 1994 after the downturn in aerospace and timber. The programs are intended to diversify the state's economy. Rather than chasing

declining industries, the strategy was changed to encourage growth in sectors already in Washington. The B&O tax and the sales tax are obstacles to expansion. The purpose of the B&O credit is to intervene early with small business, to alleviate the tax burden for these firms, and encourage investment in innovation. The Department of Revenue study shows strong results. There has been a significant increase in new companies, jobs, research and development activities, and new products since the incentives started. These incentives are imperative to the R&D core in Washington. The bill requires companies to provide information to evaluate the effectiveness of the incentives. The bill includes University of Washington and Washington State University in the program. The bill also provides an exemption for Small Business Administration grants for innovation research and technology transfer. These programs support targeted industries. These companies are under increasing pressure to move both R&D and manufacturing offshore. We need every incentive to increase growth of these industries in Washington. The incentives have met their goals. Most high tech firms are small and many customers are out of the state. Washington is a global leader and the high tech industry has diversified the economy. The expiration dates should be moved out 10 years. Employees are well paid in the high tech sector. There is a spin off effect from these firms and jobs. Questions on jobs and wages can be answered with publicly available data. There is a fierce competition for knowledge based jobs. These incentives allow additional research on important health problems. On average it takes 15 years to bring a new drug to market. Firms would like to see better data but they don't want competitors knowing what they are doing. A definition of initiation of construction needs to be established. Developers need more flexibility in passing the sales tax relief onto R&D firms. Annual reports are costly. They are not necessary if the goal is to have data for a study.

Testimony Against: Are these incentives the best way to create a vibrant economy? The Department of Revenue study shows that the growth in high tech industries was about the same in Washington as in the country. Washington's share of high tech is about the same as when the incentives started. Given the current funding problems should we gamble or should we invest in what we know works - investment in education and health care. The bill needs to include reporting by businesses using the incentives. Reporting is not out of step with what other states are requiring. Nine states require annual reporting of data from individual firms. There is not significant evidence that these incentives create jobs. We are asked to support these tax incentives on blind faith. The bill gives away scarce resources to wealthy businesses while cutting services in the budget. These incentives need to be stacked up against other spending priorities. Every study that has come out so far has failed a cost benefit analysis on job growth. If we had company specific data we would know about job creation. Tax expenditures are public spending. The Legislature gives up other spending priorities. Can we really afford this? Every other spending program has qualifications: public purpose with clear measurement standards, public disclosure, and time limits on individuals. Something is out of balance when widows and orphans carry the burden. It is time to move to a tax system that is fair, equitable, and stable. This is a piecemeal change to an unfair tax system. The bill needs a provision that guarantees appropriate disclosure about who gets funded and what they do with the money. The tax cuts are an inappropriate priority of government. These tax cuts should not be granted until the budget cuts made last year are restored. These R&D breaks are not

cost effective. Since 1995 over \$500 million - this is a massive program. The Department of Revenue study did not show a relationship between the tax credit and job growth. Will this bill help meet the basic needs of the citizens of Washington state? It is only fair that companies answer the same questions that individuals must answer when they ask for government assistance.

Persons Testifying: (In support) Jim Hedrick, Office of the Governor; Julie Sexton, Department of Revenue; Bart Phillips, Columbia River Economic Development Council; Len McComb, Amgen, Inc.; Lew McMurrin, Washington Software Alliance; Tom Ranken, Vizx Labs; Linda Hull, Washington State Biotechnology Association; and Jim Gore, Seattle Biomedical Research Institute.

(In support with amendment) Nancy Atwood, AeA; Rachel LeMieux, Moss Adams; and John Peers, Xyron Semiconductor.

(Opposed) Marilyn Watkins, Economic Opportunity Institute; Jeff Johnson, Washington State Labor Council; Ellie Menzie, Service Employees International Union; Tom Quigley, Washington Association of Churches; Paul Benz, Lutheran Public Policy; Sherri Appleton, Coalition for a Jewish Voice; Alan Mountjoy-Vennine, Friends Committee; Kevin Gladman-Coley, Childrens Alliance; Julie Watts, Statewide Poverty Action Network; Shawn Cantrell, Citizen Action; Regina Owens and Dave Gallaher, Washington Citizen Action; Bill Milton, Service Employees International Union Local 775; Marcus Courtney, WashTech/CWA; Lonnie Johns-Brown, National Organization of Women; Sandra Schroeder, Washington Federation of Teachers; and Walt Creekmore, International Union of Operating Engineers Local 302.

Persons Signed In To Testify But Not Testifying: None.